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No. 349

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IN THE

Supreme Court of the United States

GUY T. HELVERING, Commissioner of Internal Revenue,

Petitioner,

against

AMERICAN CHICLE COMPANY,

Respondent.

On a Writ of Certiorari to the United States Circuit Court of Appeals, for the Second Circuit.

BRIEF FOR RESPONDENT.

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BRIEF FOR RESPONDENT.

Opinions Below.

The opinion of the United States Board of Tax Appeals (R. 10-16) is reported in 23 B. T. A. 221. The memorandum opinion of the Board (R. 22-23) accompanying its order denying petitioner's motion for reconsideration and modification of the decision is not reported. The opinion of the Circuit Court of Appeals (R. 28-30) is reported in 65 Fed. (2d) 454.

Jurisdiction.

The judgment of the Circuit Court of Appeals was entered May 15, 1933 (R. 30), and the petition for a

writ of certiorari which was filed August 15, 1933, was granted October 9, 1933. The jurisdiction of this court rests upon Section 240(a) of the Judicial Code as amended by the Act of February 13, 1925.

Question Presented.

Did respondent, American Chicle Company, realize taxable income upon the purchase at less than their face value of bonds of Sen Sen Chiclet Company, which bonds it had theretofore assumed in connection with the purchase of the assets of the Sen Sen Chiclet Company?

Statutes and Regulations.

Revenue Act of 1926, c. 27, 44 Stat. 9:

> "Sec. 233. (a) In the case of a corporation subject to the tax imposed by section 230 the term 'gross income' means the gross income as defined in sections 213 and 217 * * * (U. S. C. App., Title 26, Sec. 985).
>
> Sec. 213. For the purpose of this title, except as otherwise provided in section 233—
>
> (a) The term 'gross income' includes gains, profits, and income derived from salaries, wages, or compensation for personal services * * * of whatever kind and in whatever form paid, or from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and

income derived from any source whatever • • • (U. S. C. App., Title 26, Sec. 954)."

The above provisions are a re-enactment of the like numbered sections of the Revenue Acts of 1921, c. 136, 42 Stat. 227, and 1924, c. 234, 43 Stat. 253 (U. S. C., Title 26, Sections 985 and 954).

"Treasury Regulations 69:

> Art. 545. *Sale and retirement of corporate bonds.*—(1) (a) If bonds are issued by a corporation at their face value, the corporation realizes no gain or loss. (b) If thereafter the corporation purchases and retires any of such bonds at a price in excess of the issuing price or face value, the excess of the purchase price over the issuing price or face value is a deductible expense for the taxable year. (See section 234 and article 563). (c) If, however, the corporation purchases and retires any of such bonds at a price less than the issuing price or face value, the excess of the issuing price or face value over the purchase price is gain or income for the taxable year."

The above Regulations are the same as those contained in Article 545 of Treasury Regulations 62 and 65 issued under the Revenue Acts of 1921 and 1924.

Statement.

The facts were stipulated before the United States Board of Tax Appeals (R. 11-13) and the summarization thereof and the statement of the case contained in petitioner's brief (pp. 4-6) is not controverted.

Summary of Argument.

The present case is not within the scope of Article 545 of the Regulations and is not controlled by the decision in *United States* v. *Kirby Lumber Co.*, 284 U. S. 1. The Regulations apply in terms only to the purchase and retirement by a corporation of *its own bonds* issued for money as part of a loan transaction. Such was the nature of the transaction in the *Kirby Lumber Co.* case which approved the Regulations.

In the present case the bonds purchased by respondent Chicle Company for less than their face amount were bonds of the Sen Sen Chiclet Company, the liability on which respondent had theretofore assumed in connection with the purchase of the assets and property of that company in 1914. Respondent therefore was not a borrower of money as was the taxpayer in Kirby Lumber Co., but was a purchaser of property subject to the bond liability. The court below correctly held that the purchase of the bonds did not result in taxable gain but was merely a factor to be considered in fixing the cost of the property to respondent, and that the determination of gain or loss must await the sale or other final disposition of the property itself.

The contention of petitioner that respondent realized a gain from dealing in its obligations and that the purchase of the Sen Sen bonds for less than their face value in itself resulted in taxable gain, is unsound and based upon a theory, not supported by the facts, that respondent made a "short sale" of the bonds when it acquired the assets and property of the Sen Sen Company. The situation presented by the facts of this case is simply

a purchase of property coupled with a payment on the purchase price during the taxable years pursuant to the obligation assumed by respondent. There has been no completed transaction, no realization of any loss or gain to respondent because respondent still owns the property on which it has settled a bond liability at less than the face amount, resulting in a lower cost of the entire property. No sale, exchange or parting with title has taken place, and there are no means of knowing whether respondent will realize a profit or a loss on the transaction until and unless it sells or disposes of the property in question.

In order to lay any basis for ascertaining a taxable gain or loss under petitioner's theory, it would seem there would have to be an appraisal of the property to determine whether the total cost was in excess or less than such appraised value. However, an attempt to determine a gain or loss on this theory where no sale or parting with title has taken place and nothing has been realized upon the transaction would be contrary to the "notion underlying our system of taxation."

The decision of the court below recognizes and gives effect to the accepted method of computing income upon the basis of annual transactions. However the method urged by petitioner would permit of the computation of taxable income upon a basis of including fictitious gains or losses not actually realized by a sale or other disposition of the property. The decision of the court below is correct and not in conflict with the *Kirby Lumber Co.* case.

ARGUMENT.

I.

This case is not controlled by *United States* v. *Kirby Lumber Co.*, 284 U. S. 1, and no taxable gain was realized by respondent upon the purchase of the Sen Sen Chiclet Company bonds.

In 1914 the respondent, American Chicle Company, acquired the assets and property of the Sen Sen Chiclet Company by purchase, taking them subject to the liabilities of the company, among which were $2,425,000 par value of bonds (R. 11). The Chicle Company was therefore obliged to meet and pay or otherwise adjust all of these liabilities in some way satisfactory to the creditors. The record does not indicate how the general liabilities were paid, settled or adjusted, but the record does disclose that so far as the taxable years here involved are concerned the Chicle Company discharged its liability on bonds having a face value of $342,500 for $289,399.65 (R. 11-13). The petitioner contends that under Article 545 of the Regulations and *United States* v. *Kirby Lumber Co.*, 284 U. S. 1, the difference between these two amounts—$53,100.65—is a taxable gain.

The respondent's contentions, which were sustained by the Board of Tax Appeals (R. 10-23) and the court below (R. 28-30), are that the purchase of the bonds was not a separate completed transaction resulting in either gain or loss but merely represented payments on the purchase price of the property acquired from the Sen Sen Company; that the determination of gain or loss on the transaction

must await the sale or other disposition of the property itself, and that neither Article 545 of the Regulations nor the *Kirby Lumber Co.* case is controlling.

At the outset it should be noted that the Regulations apply in terms only to the purchase and retirement by a corporation of *its own bonds* presumably issued for money as part of a loan transaction. Such was the nature of the transaction in *Kirby Lumber Co.*, where this court held the "clear gain" resulting from the favorable purchase and retirement of the bonds to be taxable. In that case the purchase and retirement of the bonds was the final step in a transaction involving the borrowing and repayment of money and all the factors necessary to compute the gain on the transaction were fixed and determined during the taxable year. In other words the Regulations and the *Kirby Lumber Co.* case cover a situation where a corporation is both selling and buying its own bonds in the same manner that it would deal in securities of another company, or in commodities.

In the present case, however, the taxpayer was not the borrower of money represented by the bonds, but was a *purchaser of property,* the liability on the bonds having been assumed as an incident to the purchase of the assets and property of the Sen Sen Company. The subsequent purchase and retirement of the bonds, as in the case of the settlement of other liabilities, was merely an element by which the actual cost of the property was determined and fixed and was in no sense a separate and independent transaction resulting in taxable gain. This essential difference between the transaction considered in the *Kirby Lumber Co.* case and the one presented here was clearly

recognized by the court below and formed the basis of its decision. The court said (R. 29-30):

> "We can see no difference between bonds retired in the same year and later; nor between those issued in payment for property, and an existing mortgage assumed by the buyer when the property is transferred. But the distinction does seem to us critical between obligations whose consideration is money, and those issued or assumed for property which the obligor still holds. Every increase in the value of property might indeed be treated as a 'gain', though that would involve appraising taxpayers' property each year; but such is not the notion underlying our system of taxation. The gain must be 'realized', either by a sale of the property for money, or by its exchange for something else. Section 935, title 26, U. S. Code (26 U. S. C. A. §935). When a taxpayer gets money by issuing an obligation which he later discharges for less than its face, the transaction is completed, because money need not be sold or exchanged to be 'realized'. So we read *United States* v. *Kirby Lumber Co., supra,* 284 U. S. 1, 52 S. Ct. 4, 76 L. Ed. 131. But if he buys property by an obligation in the form of a bond, note, or the like, and if it remains in kind after the debt is paid, there can be no 'gain'. The cost has indeed been definitively settled, but that is only one term of the equation; as long as the other remains at large, there is no 'realized' gain."

Moreover, the principle, that the purchase and retirement of an obligation incurred or assumed in connection with the purchase of property, represents a payment on the purchase price of the property and is not a transaction giving rise to taxable gain has heretofore been recognized and accepted by the petitioner.

In a ruling issued in 1928 it was held that the discharge of a purchase money mortgage for less than its face amount did not give rise to taxable gain but was "merely a revision of the purchase price of the property as originally agreed upon."[1] Although this ruling was issued prior to the decision of this court in *Kirby Lumber Co.*, respondent does not find that it has since been revoked or modified in any way.

Furthermore, the petitioner has acquiesced in decisions of the United States Board of Tax Appeals holding that no gain results from the discharge for less than their face amount of obligations given or assumed as part of the purchase price of capital assets. *Des Moines Improvement Co.* v. *Commissioner*, 7 B. T. A. 279, acquiescence published Cum. Bul. VII-1, page 9; *American Seating Co.* v. *Commissioner*, 14 B. T. A. 328, acquiescence published Cum. Bul. VIII-2, page 2.

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[1] "An opinion has been requested as to the effect for income tax purposes of a transaction involving the satisfaction for less than its face value of a purchase money mortgage on property bought by the M Company during the year 1926.

It appears that as part of the consideration for the property in question a purchase money mortgage for 10x dollars was given by the M Company. During the year 1927 the estate of the prior owner, desiring to realize on the mortgage, accepted the offer of the company of 7x dollars in cash in satisfaction thereof.

It is held that under the facts shown the transaction mentioned constituted merely a revision of the purchase price of the property as originally agreed upon and resulted in no income to the M Company for 1927. Proper adjustment should be made on the books of account of the company for the purpose of showing the actual cost of the property. In the event of subsequent sale of the property so acquired, the basis to be used in determining gain or loss for income tax purposes will be the amount paid in satisfaction of the mortgage (7x dollars) plus the amount of the balance of the consideration paid for the property." *IT 2406* Cum. Bul VII-1, p. 68.

The petitioner concedes that the alleged gain upon which he here seeks to impose a tax "was not a growth or increment in value of the property acquired" and admits that "such a gain would not be derived as income until the property itself is disposed of." Furthermore, petitioner does not question the holding of the court below that any attempt to determine a gain by an appraisal of the property would be contrary to "the notion underlying our system of taxation" which requires that "the gain must be 'realized', either by a sale of the property for money or by its exchange for something else" (R. 29).

The only ground urged by petitioner to sustain the tax is that respondent realized a gain from "dealings in its obligations rather than its property" (Br. p. 14); that the purchase of the Sen Sen bonds for less than their face value, in itself, gave rise to a taxable gain. This argument proceeds upon the theory that the purchase of the Sen Sen property and the assumption of the outstanding obligations was in effect a "short sale" of the bonds for a consideration in property equal in value to the face amount of the bonds; that the selling price of the bonds as well as the cost of the property were thereby definitely fixed; and that the subsequent purchase of the bonds for less than their face value completed the short sale transaction and resulted in a taxable gain.

It is submitted that this contention of petitioner disregards entirely the true nature of the transaction. What actually occurred in the present case was a purchase of property in 1914 followed by a payment on the purchase price during the taxable years pursuant to the obligation assumed. The respondent was not in any sense dealing in its obligations and the transaction had none of the char-

acteristics of a "short sale". A similar theory was advanced to sustain the tax in *Bowers* v. *Kerbaugh Empire Co.*, 271 U. S. 170, 175, but was definitely rejected by this court.

None of the cases cited and relied upon by petitioner lend any support to the contention of petitioner that the purchase of the bonds was a separate transaction giving rise to a gain.

Maryland Casualty Co. v. *U. S.*, 251 U. S. 342; *Charleston & W. C. Railway Co.* v. *Burnet*, 50 Fed. (2d) 342 (App. D. C.); *B. F. Avery & Son, Inc.* v. *Commissioner*, 26 B. T. A. 1393; *Burnet* v. *John F. Campbell Co.*, 50 Fed. (2d) 487; and *Commissioner* v. *Simmons Gin Co.*, 43 Fed. (2d) 327, all deal with the reduction or cancellation of liabilities which, when incurred, were deducted in computing net taxable income for a prior year. Such was also apparently the case in *Great Northern Railway Co.* v. *Lynch*, 292 Fed. 903.

In the instant case there is no question of restoring to taxable income an amount previously allowed as a deduction and the above cases do not touch the question here involved. Cf. *Commissioner* v. *Rail Joint Co.*, 61 Fed. (2d) 751.

Commissioner v. *Langwell Real Estate Corporation*, 47 Fed. (2d) 841, and *Chicago, R. I. & P. Railway Co.* v. *Commissioner*, 47 Fed. (2d) 990, have no relevancy since they involved situations entirely different from that presented by the facts of the instant case. Furthermore, in *Maryland Casualty Co.* v. *United States, supra*, this court did not hold as stated by petitioner (Br. p. 13) that the increase in net worth resulting from a decrease in reserves was taxable income. To the contrary the court states (p. 353):

> "* * * such deductions can be restored to income again only where it is clearly shown that the subsequent business conditions have released the amount of them to the free beneficial use of the company in a real and not in a mere bookkeeping sense * * *.
>
> "Since the findings of fact before us do not make the clear showing, which must be required, that the statutory deduction of net reserves in prior years was restored to the free use of the claimant in 1913 *it should not have been charged as income with the decrease in that year* * * *." (Italics ours.)

In *Commissioner* v. *Coastwise Transportation Corporation,* 62 Fed. (2d) 332 (C. C. A. 1) the taxpayer purchased for less than their face amount certain of its own obligations theretofore issued in part payment of a fleet of ships. Although the court expressed a belief that the case was controlled by *Kirby Lumber Co.,* it did not hold that the purchase of the obligations was a separate transaction as here contended by petitioner, but remanded the case to the Board of Tax Appeals for further hearing to determine if there had been a release of free assets as a result of the favorable purchase of the obligations. Since the transaction was essentially a purchase of property as in the present case, we believe that the court erred in holding that *Kirby Lumber Co.* was at all applicable. Furthermore, any gain computed under the holding of the First Circuit in the *Coastwise Transportation* case must necessarily be based upon an appraisal of property still owned by the taxpayer and would not represent a gain actually realized through a sale or other final disposition of such property.

On the rehearing the Board followed the decision of the Second Circuit Court of Appeals in the present case and held that the purchase of the obligations represented a

payment on the purchase price of the assets. It was further found that because of depreciation and losses sustained there had been no release of free assets and that even under the view taken by the First Circuit Court of Appeals there was no gain. *Coastwise Transportation Corp.* v. *Commissioner,* 28 B. T. A. 725. Petitioner states (Br. p. 19) that a petition for a review of the decision of the Board rendered on rehearing has been filed and in the petition for the writ of certiorari (footnote p. 8) it is stated that the new decision of the Board "is considered erroneous because of the failure to treat the retirement of the notes as separate transactions in the years in which they occur." Since the petitioner apparently agrees with the finding of the court below that taxable gains may not be determined upon the basis of appraisals but must await a sale or other final disposition of the property, it is clear that in both the present case and in the *Coastwise Transportation Corporation* case the petitioner is relying entirely upon the "short sale" theory under which it is asserted that the mere purchase of the obligations for less than their face amount gives rise to taxable gain.

The fundamental fact in this case is that the respondent was buying property and the purchase and retirement of the bonds attaching to such property was nothing more than a payment on the purchase price thereof. The contention of petitioner that respondent was dealing in its obligations and realized a profit upon the retirement of the bonds disregards entirely the real facts of the transaction and cannot be supported under any theory. Respondent submits that the court below correctly held that the present transaction was not controlled by the *Kirby Lumber Co.* case and that no gain will be realized until the property itself is sold or otherwise disposed of.

II.

The decision of the Court below is entirely consistent with the accepted method of computing income upon the results of annual transactions and should be affirmed.

Respondent submits that not only is it sound as a matter of law to consider the amount paid to retire the obligation as a factor in the determination of the cost of the property but that any proper accounting or business view of the present state of facts would not regard the transaction otherwise. The record does not indicate at what price the bonds were selling in the market at the time of the purchase of the assets of the Sen Sen Company but it is fair to assume that if they were selling at a discount this fact was taken into consideration at the time of the purchase and was a factor in determining the purchase price. It is also reasonable to conclude that when a business is purchased subject to the payment of its liabilities, the purchaser has in mind the possibility of paying off the liabilities for less than their face amount and considers that the actual cost of the property will be the amount paid at the time of the purchase plus the amount subsequently required to settle or dispose of the liabilities.

The petitioner argues (Br., p. 21) that if a corporation acquires property by assuming obligations and sells the property the following year but does not retire the obligations until twenty years thereafter, no gain or loss could be computed upon the sale of the property under the decision of the court below, until the obligations had been retired. Respondent submits that there is nothing in the

reasoning of the court below which puts any limitation upon the accepted method of computing gains upon the basis of annual transactions or which would require or permit computations of gains or losses to be made in the manner as stated by petitioner.

Where real property is acquired by the assumption of an obligation such obligation is ordinarily a lien upon the property itself and any subsequent sale of the property before the obligation is retired will in turn be made subject to such obligation. In such a case it is apparent that there would be no difficulty in computing gain or loss upon a sale of the property whether or not the obligation ha been retired prior thereto. If the obligation assumed was not a lien upon the property itself and was not retired prior to a sale of the property, the face amount of the obligation would be used in fixing the cost of the property for the purpose of computing gain or loss upon the sale. In that event the "cost basis" of the obligation would be fixed and if thereafter the obligation was discharged for less than its face amount taxable gain would be realizable.

It is submitted, however, that a computation of gains or losses in the manner contended for by petitioner would result in the taxing of gains not actually realized and result in distortions of income not consistent with the accepted method of computing income upon the basis of annual transactions. This is clearly shown by the following illustration:

Assume that A purchased an apartment building in 1926 for $100,000 paying $25,000 in cash and assuming a mortgage for $75,000. Thereafter, in 1932, A retired the mortgage obligation by the payment of $50,000 and in 1933 sold the property for $60,000. Disregarding any adjustment for depreciation, it is clear that A sustained an actual loss in

1933 of $15,000 upon the sale of the building. However, under the petitioner's theory A would be held to have realized a gain of $25,000 in 1932 upon the retirement of the mortgage and to have sustained a loss of $40,000 in 1933 upon the sale of the property. Under the decision of the court below the retirement of the mortgage in 1932 would properly be considered as an adjustment of the purchase price and the actual loss of $15,000 would be shown as having been sustained in 1933 when it was realized by the sale of the property.

The holding of the court below that no gain can be realized until the property itself is sold is entirely consistent with the accepted method of computing gains upon the basis of annual transactions and gives effect to the true nature of the transaction which was simply a purchase of property and the payment on the purchase price thereof in a subsequent year pursuant to the obligations assumed by petitioner.

Conclusion.

It is respectfully submitted that the decision of the court below is correct, is not in conflict with the decision of this court in *United States* v. *Kirby Lumber Co.*, 284 U. S. 1, and should be affirmed.

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